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OPEC Announced Surprise Agreement to Cut Production

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On September 28, the Organization of the Petroleum Exporting Countries (OPEC) suddenly opened its extraordinary meeting in Algiers where a ministerial conference of the International Energy Forum was held. After its 170th meeting, OPEC announced an agreement to reduce the 14 member countries' crude oil production to a target range between 32.50 million and 33.00 million barrels per day based on an analysis of the present and future international oil market. From the August OPEC production level estimated by the OPEC Secretariat at 33.24 million bpd (against 33.47 million bpd as estimated by the International Energy Agency), the target range represents the maximum production cut of a little more than 700,000 bpd.

The announcement of the production reduction agreement defied a dominant prediction by market players, coming as a surprise to them. As noted in my previous bulletin (A Japanese Perspective on the International Energy Landscape (290)), the dominant prediction was that major oil producing countries would fail to form any effective agreement due to wide differences over production adjustments between major oil producing countries, particularly between Saudi Arabia and Iran. Just before the OPEC meeting, I visited the United Kingdom for talks with local energy experts, who were mostly pessimistic about any agreement among oil producing countries. The Financial Times on September 28 carried a story headlined "Iran rejects output cap and wrecks Saudi bid to reverse oil price slide," indicating that it would be difficult for oil producing countries to form any agreement.

In response to the surprise or unexpected oil production reduction agreement, crude oil market prices soared. On September 28, the key Brent futures contract rose by $2.72 per barrel (or 5.9%) from the previous day to $48.69/bbl. On September 29, the contract gained $0.55/bbl to $49.24/bbl coming closer to the $50/bbl level. The rise represented a market response to a surprise.

Why did OPEC reach the agreement in defiance of dominant expectations? This is the next question to be asked. The biggest reason is that the unexpectedly prolonged weakness of crude oil prices has seriously affected oil producing country economies. In oil producing countries that feature a vulneable economic structure depending heavily on oil (and gas) export income, plunges and continued weakness of oil prices since the second half of 2014 have seriously affected tax revenues, budget balances and gross domestic product through substantial falls in export income. Impacts of weak oil prices are particularly serious in oil producing countries that have large populations, see growing young populations or are forced to expand spending for various domestic and external reasons. In this sense, the impacts of weak oil prices on the world's largest oil exporter Saudi Arabia may be far more serious than expected.

What would have happened if oil producing countries at their latest meeting had failed to produce any effective agreement (as predicted dominantly)? Probably, selling on disappointment could have accelerated price declines in the market plagued with oil glut concerns. The key West Texas Intermediate futures contract, which had slipped below $45/bbl on September 27, could have declined further to less than $40 if without the OPEC agreement. As a view that it would take more time than expected to eliminate the oil glut even amid the ongoing rebalancing of international oil supply and demand grew dominant, oil producing countries including Saudi Arabia might have wanted to avoid any further oil price plunge. A dominant view is that Saudi Arabia changed its policy to compromise on the agreement on the production ceiling for the whole of OPEC without Iran's individual commitment to freeze any oil production increase, contributing to the agreement.

In fact, the OPEC agreement has successfully avoided a crude oil price plunge that could have come if without the agreement. The surprise announcement has successfully created a momentum for price hikes. However, no optimism may be warranted about the sustainability of the upward momentum. This is first because no specific path to achieving the announced production target is seen at present. While the production target for the whole of the OPEC members has been set, how individual countries should reduce production and how the reduction should be secured remain undecided. At present, all major oil producing countries are ambitious to secure their respective market shares. The focus of attention in the market will shift to the feasibility of the production target. Second, even if the high end of the production target range is achieved, production may change little from the historically high level at present. In such case, the production reduction agreement would be found to have made limited contributions to improving the oil supply-demand balance. In this sense, how long the surprise effect would be sustained may attract much attention.

Given that crude oil prices have risen close to $50/bbl, they could increase beyond the level. Then, however, market players may speculate that U.S. shale oil production could decelerate a decline or turn up. As a matter of course, the crude oil price level of $50/bbl may fall short of leading shale oil production to substantially increase as seen between 2012 and 2015. As far as market participants expect that price hikes would stimulate a production expansion, however, oil prices may become top-heavy.

However, the latest OPEC meeting successfully led market participants to pay attention to OPEC again. It contributed to changing the impression of OPEC failing to decide anything even in the face of oil price plunges. OPEC might have bought time in the market, which has avoided a further fall coming if without the agreement and is going in the direction of rebalancing while consuming time. While various turbulent factors are expected to arise for oil prices, market players have paid attention to OPEC again. Over the two months before the regular OPEC meeting on November 30, we will have to closely watch market developments regarding the feasibility and impacts of the production reduction agreement.

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